# United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 12506

WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DUP. BAYARD, Receiver,
*Plaintiffs-Appellants,*

and

MEREDITH H. METZGER, HENRY OFFERMAN and J. S. FARLEE & CO., INC.,
*Plaintiffs-Intervenors-Appellants,*

VS.

WESTERN PACIFIC RAILROAD COMPANY, et al.,
*Defendants-Appellees.*

## REPLY BRIEF FOR PLAINTIFFS-INTERVENORS APPELLANTS

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## REPLY BRIEF FOR PLAINTIFFS-INTERVENORS APPELLANTS

This brief will show, (1) that the arguments on the merits, advanced in defendants-appellees' brief ("DB" hereinafter), are without substance (Points I and II, *infra*); (2) that the alleged defense of bankruptcy bar (DB 68) is contrary to an express statute and to an unbroken line of authorities (Point III, *infra*); and (3) that the defenses of res judicata and statute of limitations—half-heartedly asserted in a footnote (DB 82)—are equally untenable (Point IV, *infra*).

The factual inaccuracies of appellees' brief will be corrected only where necessary in the context of our discussion. Appellees' individual arguments, however repetitious,* will be answered only once. Nor shall we stop to rebut appellees' charge (DB 15) that our main brief is

* Thus the argument based on the alleged tax practice of the Western Pacific group appears not less than fifteen times (DB 7, 12, 15, 18, 19, 22, 30, 37-38, 42 [twice], 52, 58, 59, 63, 65-66).

"replete with erroneous and misleading statements," since that is refuted by the record.*

On the merits we believe that the case cannot be disposed of by broad generalizations such as that plaintiff has "no standing in court" because its claim does not fit the conventional categories of "tort", "contract" or "statutory right" (DB 24). The case, as we see it, turns on two questions: Was the relation between the parties such as to subject defendant to the fiduciary duty of dealing fairly with plaintiff? And, if so, did fairness require defendant to allow plaintiff all or at least a substantial share of the tax savings which defendant derived from the use of plaintiff's tax credit? We turn to answering appellees' arguments as they bear on these questions.

## POINT I

**Defendant was obligated to deal fairly with plaintiff because of the duality of management and because of defendant's control of the tax transaction.**

**A. Contrary to appellees, the fiduciary relation between the parties is highly relevant because it subjected defendant to the strict duty of dealing fairly with plaintiff.**

According to appellees (DB 22), the only question in this case is whether defendant's use of plaintiff's tax credit was sufficient, *per se,* to vest a money claim in plaintiff. If not, then, it is said, "arguments about fairness, duality and fiduciary obligations are all irrelevant" (DB 22).

The argument is patently wrong. "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties"; *Meinhard* v. *Salmon,* 249 N. Y. 458, 464, 164 N. E.

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* Most of appellees' charges are inconclusive on their face. Thus our statement that Curry was a "chief clerk or office manager", based on Curry's testimony (R. 639), is hardly contradicted by the trial judge's remark that Curry was competent, intelligent and "probably" a pretty good railroad man (DB 15).

545 (1928, Cardozo, J.). Had this defendant been a complete stranger to plaintiff, it would have been free to make self-interest the sole guide of its actions. But if defendant was a fiduciary, it bears the burden "not only to prove the good faith of the transaction, but also to show its inherent fairness"; *Pepper* v. *Litton,* 308 U. S. 295, 306 (1939). The existence of a fiduciary relation is therefore highly relevant since it establishes fairness as the test by which defendant's conduct in the tax transaction is to be measured.

**B. Duality of management and control of the tax transaction by defendant were found by the Court below, are indisputable, and establish defendant's duty to deal fairly with plaintiff in the tax transaction.**

1. The findings of the District Court are unambiguous:

> "It was there [in the supplementary complaint] further alleged that the defendant through its officers and attorneys had controlled the board of directors of the plaintiff corporation and that by reason of such control plaintiff was caused to file the consolidated returns for the benefit of the defendant. Throughout the proceedings and in the trial, this has been referred to as 'duality of control'."
>
> (R. 264)
>
> "* * * there is a preponderance of the evidence in favor of the plaintiff's contention of 'duality of control'."
>
> (R. 272)

This finding, which appellees neither claim nor show to be "clearly erroneous", is binding here; Rule 52(a) F. R. C. P.

2. Appellees nevertheless ignore it. They blandly assert (DB 34) that plaintiff had "control over the tax transactions" because "the returns could not be filed except as they were signed and filed by the Corporation"; so that "the final decisions were necessarily made by the Corporation when it filed the returns" (DB 34).

These assertions are contrary not only to the finding of the Court below, but to the record. Plaintiff's boar of directors made no "final decisions" because it was neve consulted (R. 663-4, 666-7, 1018). And Curry, who signe the returns as plaintiff's president, likewise made no "fina decisions" for plaintiff because he was actually a mer chief clerk or office manager (R. 639), in the exclusive pa of defendant (R. 1738), had no understanding of tax mat ters (R. 808), and signed the returns only because h was told that Polk, defendant's tax counsel, had approve them (R. 664, 666). The truth is that the "final decisions emanated from defendant, as is shown by the testimon of Mr. Polk, attorney for one of the appellees and calle as a witness by appellees:

> "Q. Who made the decision [to use the stock loss]
> A. Mr. Elsey, Mr. DeGraff [i.e., defendant's presiden and defendant's general auditor, R. 1251, 1408]."
>
> (R. 1448)

> "A. The decisions to file the returns were, of course made by the company [i.e., defendant]."
>
> (R. 1450)

3. Given duality of management, which is undisputed and control of the tax transaction by defendant, which wa found by the Court below and is established by the record defendant's duty to deal fairly with plaintiff in the ta transaction follows of necessity. The cases cited in ou opening brief ("IntOB" hereinafter), pp. 28-29, so hold and appellees' authorities confirm the same rule. Thus *Hellier* v. *Baush M. T. Co.*, 21 F. 2d 705, 707 (C. C. A. 1 1927), discussing a transaction between two corporations having common directors, quotes from 3 *Cook on Corporations*, § 662:

> "If the transaction is fair, the court will sustain it; if it is unfair, the court will undo it."

We submit, therefore, that fairness is the standard by which the tax transaction between plaintiff and defendant must be judged.

**[illegible]. Plaintiff owed no fiduciary duty to defendant; but even if it did, defendant nonetheless also owed fiduciary duties to plaintiff.**

In an attempt to exonerate defendant from any fiduciary duties to plaintiff, appellees argue that, on the contrary, plaintiff, as the holding company, was the fiduciary of defendant, its subsidiary (DB 30-32, 41, 66). But this argument has already been answered (IntOB 66, 67); and it is indeed untenable.

1. A holding corporation as such is not a fiduciary of its subsidiary; *Blaustein* v. *Pan American P. & T. Co.*, 263 App. Div. 97, 119, 31 N. Y. S. 2d 934, 956 (1st Dept., 1941), aff'd 293 N. Y. 281, 56 N. E. 2d 705 (1944). It becomes a fiduciary only by controlling the subsidiary's affairs. "It is the fact of control * * * that creates the fiduciary obligation"; *Southern Pacific Co.* v. *Bogert,* 250 U. S. 483, 492 (1919). Appellees' thrice-cited authority, *Consolidated Rock Products Co.* v. *DuBois,* 312 U. S. 510, 522 (1941), stands for the same proposition, as appears from the court's language, omitted from appellees' quotation (DB 31).*

During the critical period plaintiff had no vestige of control over defendant. Up to December 31, 1944, defendant was in the hands of its court-appointed reorganization trustees; after that date, the reorganized defendant was owned and controlled by its new stockholders. Appellees do not claim that plaintiff dominated the trustees or the new management of defendant. Their argument that plaintiff was a fiduciary of defendant is therefore without basis.

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* The Supreme Court's complete language reads (312 U. S., at 522):

> "But equity will not permit a holding company, *which has dominated and controlled its subsidiaries,* to escape or reduce its liability to those subsidiaries by reliance upon self-serving contracts which it has imposed on them. A holding company, *as well as others in dominating and controlling positions* (*Pepper* v. *Litton,* 308 U. S. 295), has fiduciary duties to security holders of its system which will be strictly enforced."

Appellees' quotation (DB 31) omits the language here italicized.

2. It is also irrelevant. Even if it were assumed *arguendo,* that plaintiff was under fiduciary obligations to defendant, defendant was certainly likewise subject to fiduciary duties to plaintiff. Mutual fiduciary duties are not uncommon in the law, as in the case of partners or joint venturers. If it were thought that the present parties owed fiduciary obligations to each other, the result would still be the duty to deal fairly; and that is all we contend for.

Appellees' other arguments pertaining to duality—such as the alleged absence of secrecy (DB 32-33), the alleged creation of duality by plaintiff (DB 36), and the alleged inapplicability of the duality rule to reorganization trustees and their employees (DB 37)—have been dealt with in our opening brief (IntOB 32-35). Since appellees do not undertake to answer what we there said, it need not be repeated here.

We proceed, therefore, to discuss what the requirements of fairness were in the tax transaction between these parties.

## POINT II

**Fairness required defendant to allow plaintiff all or at least a substantial part of the tax savings.**

Although appellees contend (DB 38) that "fairness" is too vague a standard by which to judge defendant's conduct, it is the customary and time-proved test; *Ewen* v. *Peoria & E. R. Co.*, 78 F. Supp. 312, 316 (S. D. N. Y. 1948, L. Hand, C. J.), cert. den. 336 U. S. 919. Guidance for its application is found in appellees' own authorities, for they hold that, when the fairness of a transaction between fiduciary and cestui is in issue, the touchstone is "whether the proposition submitted would have commended itself to an independent corporation"; *Ewen* case, *ibid.*, quoting from *International Radio Telegraph Co.* v. *Atlantic Communication Co.*, 290 Fed. 698, 702 (C. C. A. 2, 1923).

Had plaintiff been an "independent corporation", under a management wholeheartedly devoted to its sole interest, it would have found literally nothing to commend this transaction by which plaintiff conferred a $17,000,000 tax benefit on defendant without receiving any benefit whatever. Corporations are not organized to distribute largesse to strangers. An independent management of plaintiff, competent and well advised, would have considered that plaintiff's tax credit was allowed by law in order to mitigate its stock loss, not to give a tax windfall to the prosperous defendant; that plaintiff might have opportunities to use the tax credit for its own benefit; that, by joining in consolidated returns, plaintiff would subject itself to liability for any tax deficiencies of defendant; that defendant, economically a total stranger to plaintiff, was anxious to obtain the benefit of plaintiff's tax credit; and that plaintiff was under no obligation to surrender it to defendant. Under these circumstances the proposition that plaintiff surrender its tax credit to defendant without assurance of a fair share in the resultant savings, was utterly unfair and plaintiff would have been fully justified in rejecting it.

None of appellees' arguments can shake this conclusion.

**A. The purpose of the tax laws was to benefit plaintiff.**

1. *The purpose of Internal Revenue Code, § 23(g)(4):* This section allowed plaintiff a tax credit for the loss of its $75,000,000 stock investment in defendant. We have shown (IntOB 38-39) that the provision was intended for plaintiff's benefit in order to mitigate its loss. Appellees' silence on this point indicates that they do not dispute this proposition.

2. *The purpose of Internal Revenue Code, § 141:* This section permits the filing of consolidated tax returns by an affiliated group of corporations. We have shown (IntOB 39-42) that the provision was intended for the benefit of the parent corporation of the group. In an

economic sense the parent, in effect, owns the assets of all group members; their profits and losses are actually the profits and losses of the parent; the right to offset such profits and losses is thus granted for the parent's benefit and any incidental tax savings of a subsidiary redound to the benefit of the parent by the automatic operation of economic factors, i.e., the increased value of the parent's stock in the subsidiary or the payment of dividends.

Appellees consider this a "singularly unsophisticated" view of holding company systems (DB 50, 61-63). Consolidated returns may be filed, according to appellees' twice-repeated but nevertheless incorrect paraphrase of the statute, "whenever 95 per cent of the voting stock is within the system" (DB 50, 61-62).* Subsidiaries, even though thus affiliated with a holding company, frequently have senior securities (preferred stock, notes and bonds) outstanding with the public. It follows, say appellees, that holding company systems filing consolidated returns are not ordinarily "single ownerships" (DB 50) and that their "economic unity" is "a false factor demonstrably of no significance" (DB 61).

But our position, however unsophisticated, happens to be that of Congress, of the Treasury Department, of the Supreme Court, and of other courts analyzing the rationale of consolidated returns. Thus the *Report of the Senate Finance Committee,* 70th Cong., 1st Sess. S. R. 960, p. 14 (1928):

> "Much of the apprehension about consolidated returns will be removed when it is realized that *it is only when the corporations are really but one corporation that the permission to file consolidated returns is given,* and that no ultimate advantage under the tax laws really results. The present law permits the filing of consolidated returns only where one corpora-

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* Actually § 141(d) requires also 95% ownership of nonvoting stock, except such as is "limited and preferred as to dividends". Contrary to appellees' contention (DB 50), the 95% requirement applies therefore to all equity stock, voting or nonvoting.

> tion owns at least 95 per cent of the stock of the other corporation or if at least 95 per cent of the stock of both corporations is owned by the same interest. The provision embodies the business man's conception of a practical state of facts." (Italics added)

Congress, concededly familiar with the subsidiaries' practice of issuing senior securities to the public (DB 50), thus considered, nevertheless, the ownership of 95% of their equity stock sufficient to constitute parent and subsidiary as "really but one corporation". Congress thus recognized the "economic unity" of parent and subsidiary as the legislative justification of consolidated returns.*

So did the Treasury Department and the Supreme Court. In *Atlantic City E. Co.* v. *Commissioner,* 288 U. S. 152, 154 (1933), the Supreme Court stated:

> "The requirement of consolidated returns was 'based upon the principle of levying the tax according to the true net income and invested capital of *a single business enterprise,* even though the business is operated through more than one corporation.' Treasury Regulations No. 45, Art. 631." (Italics added)

The reference by the Treasury Department and the Supreme Court to the "single business enterprise operated through more than one corporation" as furnishing the basis for consolidated returns confirms that these authorities, too, conceived holding company systems filing consolidated returns as "single ownerships" or "economic units"—the very proposition which appellees would like to reject.

Reference may finally be made to *Ice Service Co.* v. *Commissioner,* 30 F. 2d 230, 231 (C. C. A. 2, 1929):

> "The theory of affiliation resulting in a consolidated return for taxes is that the income and invested capital are really the income and capital of a single enterprise,

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* Appellees' argument that the economic unity of an affiliated group is destroyed if a subsidiary has mortgage bonds outstanding, would mean, in effect, that even a single corporation, part of whose property is mortgaged, is no longer an economic unit. That is hardly "the business man's conception of a practical state of facts."

> though carried on through the instrumentality of several corporations. [Citing authorities.] Only when the outside interest—that is, the interest of the minority—is so small as to be practically negligible are the two corporations to be treated as in receipt of a single income, requiring a consolidated return."

Consolidated returns are thus permitted because the income and losses of the subsidiaries are, in an economic sense, the income and losses of the parent. As the common owner of the enterprise, the parent suffers from the losses sustained by any member of the affiliated group; and the parent is the ultimate and intended beneficiary of any tax savings which any group member derives from the filing of consolidated returns.* "The benefit of the statute extends to him on whom is the hazard of the several enterprises", i.e., the parent; *Alameda Investment Co.* v. *McLaughlin,* 28 F. 2d 81, 82 (D. C., N. D. Cal., 1928), aff'd 33 F. 2d 120 (C. C. A. 9, 1929).

Appellees' analogy of this case to *Hopkins* v. *Detrick,* 97 A. C. A. 55, 217 P. 2d 78 (1950), is misplaced. The court there denied a husband's claim to tax refunds which might be payable to his wife. But the court's opinion does not disclose the basis of the claim or the nature of the tax refunds; the reference to "saved" taxes, although quoted by appellees (DB 44), is not in the opinion. Nor does it appear that the wife had utilized a tax credit belonging to the husband or that, by filing joint returns reporting her earnings as community property, she had breached a fiduciary duty to her husband, or that a tax statute intended for the husband's benefit was involved. Appellees'

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* Appellees say (DB 63) that the automatic upstream flow of the subsidiary's tax savings to the parent will not take place if the subsidiary's bonds are in default, its debenture interest unpaid, preferred stock in arrears or general creditors unsatisfied. But, actually, any tax saving of the subsidiary will reduce these senior charges and thus improve the value of the parent's equity stock in the subsidiary, unless and until an approved reorganization plan of the subsidiary cuts off the parent's interest in the assets and earnings of the subsidiary—which is the case at bar.

other authority, *Cooper* v. *Central Alloy Steel Corp.*, 43 Ohio App. 455, 183 N. E. 439, 444 (1931), has nothing in common with this case except isolated phrases which appellees cite out of context.

**B. The purpose of the tax laws was foiled by the economic severance of the parties.**

The Supreme Court's decision of March 15, 1943, affirming defendant's reorganization plan, eliminated plaintiff's stock interest in defendant and thereby cut off the automatic upstream flow to plaintiff of any tax savings which defendant thereafter might derive from the filing of consolidated returns and the use of plaintiff's tax credit. Under these circumstances, defendant's retention of all the tax savings and the denial of any share therein to plaintiff were contrary to the purpose of both I. R. C. § 23(g)(4) and § 141 and hence unfair to plaintiff.*

1. Appellees claim (DB 60) that the Supreme Court severed nothing, but merely rendered the severance probable. But appellees themselves gave the answer in Polk's letter to the Internal Revenue Department, dated May 31, 1946 (Pl. Ex. 64, R. 1779), which concludes that plaintiff's stock in defendant

> "at all times, until the date of the Supreme Court decision March 15, 1943, had a real and material fair market value, and that the stock became worthless on or after March 15, 1943 * * * "
>
> (R. 1783)

* Appellees say that "the revenue acts create no private rights" (DB 48). We agree. But under general law, tax transactions may give rise to a multitude of private rights, such as contribution, *Phillips-Jones Corp.* v. *Parmley*, 302 U. S. 233 (1937), or accounting, *Truncale* v. *Universal Pictures Co.*, 76 F. Supp. 465 (D. C., S. D. N. Y., 1948), *Commercial National Bank in Shreveport* v. *Parsons*, 144 F. 2d 231 (C. C. A. 5, 1944), or contract, *Matter of Consolidated Electric & Gas Co.*, 15 S. E. C. 161 (1943).

Even much earlier the lawyers had advised that:

> "The stock of the Western Pacific Railroad Company should be written down to $1 as of the date of the Supreme Court decision approving the I. C. C. plan of reorganization * * * wherein the stock is declared worthless."
>
> (R. 561-2)

In any event, appellees concede and, indeed, proclaim that "the returns were proper under the tax laws" (DB 18). This means that defendant's stock became "completely worthless" (DB 39) in 1943; and it is not too important whether that happened on March 15 or some other date in 1943. Certainly the economic unity was severed when the returns were filed in 1944 and 1945. Appellees' denial that the Supreme Court's decision severed the economic unity is thus not only contrary to fact, but irrelevant.

2. It is also inconsistent with appellees' other argument, namely, that the economic unity of the Western Pacific group had ceased long before March 15, 1943 (DB 60-61). Appellees' latter contention is as untenable as their first. As pointed out in Polk's letter already mentioned, defendant's reorganization plan had been reversed by this Court on November 28, 1941 (*In re Western Pac. R. Co.*, 124 F. 2d 136) because of the Commission's and the District Court's failure to make findings which would justify the elimination of plaintiff's stock interest in defendant (R. 1781). This Court's decision thus "was a practical assurance of participation in the reorganization by the equity ownership", i.e., plaintiff (R. 1782). Only after this Court's decision was in turn reversed by the Supreme Court on March 15, 1943, were the worthlessness of plaintiff's stock in defendant and the severance of economic unity established facts.

From this time on, we submit, the purpose of the tax laws—to mitigate plaintiff's loss and to benefit it as the parent of the affiliated group—could be accomplished only by an arrangement between plaintiff and defendant allowing plaintiff all or at least a substantial share of the tax savings.

**C. The alleged twenty years' tax practice of the Western Pacific group is contrary to fact and, in any event, furnishes no test of what would have been fair after the economic severance of the parties.**

Appellees' argument (DB 59, 65) runs: During the years prior to 1943 plaintiff, defendant and their affiliates had consistently filed consolidated tax returns. The taxes paid by plaintiff pursuant to such returns were allocated among the various affiliates having taxable income in proportion to the amount of such incomes. Affiliates who contributed a loss and thereby reduced the consolidated tax are said to have received no payment for contributing their loss. Such having been the practice before 1942, appellees say it would have been unfair for plaintiff to demand a change in 1943 and thereafter, when such change would be to plaintiff's advantage.

The argument does not stand analysis.

1. It is factually unsound. During the years from 1918 to 1924, one of the affiliates joining with plaintiff and defendant in consolidated returns did make substantial "tax savings payments" to plaintiff, as is more fully demonstrated in the footnote.*

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* The affiliate was the Utah Fuel Company. The facts appear from a Price, Waterhouse report (Def. Ex. 40). Page references in this footnote refer to said Defendants' Exhibit 40.

In the interest of brevity, we confine ourselves to the taxes for the year 1923, other years being similar. In 1923 the separate income of Utah Fuel Company (including its subsidiaries) was $1,053,957.73 (pp. 6, 13). At the then prevailing 12½% tax rate, the income tax payable by Utah Fuel Company, on a separate basis, would have been $131,744.72.

Utah Fuel Company however joined with plaintiff and the other members of the Western Pacific group in a consolidated tax return. Plaintiff had sustained a substantial loss in 1923 (p. 13). The total consolidated tax amounted therefore to only $71,268.88 (p. 13); and the proportionate share of Utah Fuel Company in the consolidated tax would have been only a fraction of this $71,268.88.

But actually the benefit of this tax reduction was not passed on to Utah Fuel Company. On the contrary, Utah Fuel Company

2. Appellees' argument also ignores their other contention that the pre-reorganization defendant and its reorganization trustees were altogether "distinct entities" (DB 2). The pre-reorganization practice of plaintiff and defendant certainly could not pre-judge what should be done as between plaintiff and the trustees. During the reorganization years 1936 to 1941 neither plaintiff nor defendant's trustees had taxable income (Def. Exs. 46, 47, R. 2040-1), so that no tax problem could arise. And when defendant's trustees for the first time realized income in 1942, they felt so little bound by the previous tax practice that they retained tax counsel to obtain their advice on the "very critical question" of whether consolidated or separate returns should be filed (Pl. Exs. 39-B, 39-D, R. 544, 546).

3. In any case, the tax practice of the Western Pacific group in earlier years is totally irrelevant to the events of 1943 and thereafter. The $593,976.33 tax savings which plaintiff is said to have derived by filing consolidated returns (DB 59, 65), accrued during the period from 1924 to 1935 (DB 65; R. 2040). During this period, the Western Pacific group was an economic unit; tax savings payments would have been unnecessary and pointless since all tax savings automatically redounded to the benefit of plaintiff, the common parent. Thus, if plaintiff sustained a loss and one of its subsidiaries profited, the tax saving of the subsidiary became automatically the tax saving of the parent, so that the formality of a tax saving payment was superfluous. Conversely, if plaintiff had a profit and one

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paid the full sum of $131,744.72 (p. 6), i.e., the tax it would have had to pay on a separate basis. It paid

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|---|---|---|
| to the Government: | $71,268.88 | |
| to plaintiff: | $60,475.84 | (p. 6) |
| Total paid by Utah Fuel Co.: | $131,744.72 | (p. 6) |

This transaction is thus a clear instance of a "tax savings payment" and refutes appellees' contention that consolidated taxes were apportioned among the income companies of the Western Pacific Group in the proportion of their respective incomes.

of its subsidiaries a loss, a tax saving payment by the parent to the subsidiary would have been as meaningless as it would be for an individual to shift money from one pocket to another. So long as the Western Pacific group constituted an economic unit, there was no reason or purpose for making tax savings payments.

But the situation was quite different when, on March 15, 1943, the economic unity of plaintiff and defendant was severed. From that time on, the automatic upstream flow of defendant's tax savings was interrupted. The tax savings of defendant were no longer the tax savings of plaintiff. Hence it was at this point, and not before, that an adjustment of tax savings between defendant and plaintiff became important and necessary.

We submit that the alleged absence of tax savings payments during the period before 1943—when such payments would have been unnecessary and meaningless—furnishes no test for the years 1943 and thereafter when the usefulness and significance of such payments first arose.

**D. The precedents allegedly militating against tax savings payments deal with unified groups of corporations and are therefore inapplicable where, as here, the economic unity has been severed.**

Appellees contend (DB 52-58) that it is the "general business practice" of affiliated groups to allocate the consolidated tax to the income companies of the group, without any allowance to loss companies; that various administrative agencies (the Treasury, the F. T. C., the S. E. C., the I. C. C.) have advocated this practice; and that therefore fairness did not require defendant to allow plaintiff a share of its tax savings.

The principal trouble with this argument is that the so-called precedents dealt with the normal situation of a consolidated return filed by an economically unified group of corporations; whereas the very basis of our claim lies in the economic severance of the parties. None of appellees' precedents deals with such a situation; none is therefore here pertinent.

But appellees' arguments are unsound for additional reasons.

1. *The Treasury Department.* Appellees' argument postulates a rigid rule requiring that tax savings arising from consolidated returns must be allocated to the income companies of the group in proportion to their incomes, without any allowance to the loss companies. But the simple fact is that no such requirement exists. On the contrary, Treas. Reg. 104, § 23.15(d) expressly recognizes the freedom of the group members to agree on such allocation of the tax burden as they see fit (IntOB 50-51).

Appellees (DB 56) invoke certain Treasury rulings—I. T. 3637 and I. T. 3692 (DB App. 17, 21)—as supporting their position. But these rulings deal with a specific narrow problem not here pertinent; * and the rulings carefully emphasize that:

> "The [Internal Revenue] Bureau is not concerned with arrangements made between affiliated companies as to the payment of the [consolidated] tax. * * * As a matter of fact one of the affiliates may make all of the tax payments via the parent corporation, * * * "
>
> I. T. 3637 (1944 Cum. Bull. 258; DB App. 20)

Nothing in the Treasury Regulations prevented therefore these parties from arranging for a fair division of the tax savings.

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* Internal Revenue Code, § 115 defines "dividends" as payments made by a corporation to its shareholders "out of its earnings or profits". Once a corporation has earnings or profits available for the distribution of dividends, then a distribution made by the corporation to its shareholders will be deemed a "dividend" to the extent of the available earnings or profits (§ 115 (b)).

This statute made it necessary to define the concept of "earnings or profits available for dividends" in situations where consolidated tax returns are filed. I. T. 3637 and I. T. 3692 furnish that definition. But these rulings do not pre-judge the right of affiliated companies to make such tax allocations *inter sese* as they may see fit.

2. *The alleged "general business practice"* does not exist. The Western Pacific group itself deviated from it (*supra*, p.       ); and the Report of the Federal Trade Commission * (DB App. 2) enumerates many instances of tax savings payments which were approved by the appropriate state regulatory commissions (see DB App. 2-3).

3. *The Federal Trade Commission.* It is true, as appellees say (DB 50, 57), that the F. T. C. criticized tax savings payments and recommended the enactment of legislation absolutely forbidding them (DB App. 6). But, as we have shown (IntOB 52), the recommendation was limited to the field of public utilities; and, in any case, it was not adopted by Congress. The F. T. C.'s Report, and expressions based thereon such as those of Senator Wheeler (DB 51), are therefore not indicative of Congressional policy. Congress, instead of adopting the rigid prohibition proposed by the F. T. C., left the matter for regulation by the S. E. C.; Public Utility Holding Company Act, § 12, 15 U. S. C., § 79l.

4. *The Securities and Exchange Commission,* pursuant to this Congressional authorization, adopted its Rule U-45(b)(6) which we have extensively discussed (IntOB 44-49). The Rule, as we have shown, is not mandatory, but flexible; while stating the normal rule of proportional allocation, it allows exceptions; and, in the exercise of this latitude, the S. E. C. has repeatedly permitted tax saving payments to be made to loss companies where required in the interest of fairness (see cases cited IntOB 45, 46, 49).

5. *The Interstate Commerce Commission.* Appellees admit (DB 58) that the I. C. C. has not dealt with the prob-

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* *Federal Trade Commission, Summary Report to the Senate of the United States*, pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Economic, Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A, Sen. Doc. No. 92, 70th Cong., 1st Sess.

lem of the allocation of consolidated taxes. The two I. C. C. decisions cited by appellees (DB 58) bear no relation to the issues at bar.

**E. Plaintiff was under no obligation to make its tax credit available to defendant.**

Appellees reiterate with great insistence that plaintiff was obligated to minimize defendant's taxes by making its tax credit available to defendant (DB 32, 40, 41, 59, 66). They invoke two grounds: Plaintiff, they say, was a fiduciary of defendant (but see *supra,* pp. 5-6); and the Bankruptcy Act obligated plaintiff, as stockholder, to preserve defendant's assets. Both arguments have been answered in our opening brief (pp. 66-68). Here we confine ourselves to certain supplementary observations.

1. Appellees say that the bankruptcy court could and would have compelled plaintiff to join in consolidated returns (DB 40-41). But apart from the jurisdictional impossibility of such action, *Callaway* v. *Benton,* 336 U. S. 132, 141-9 (1949),* the argument begs the question: The bankruptcy court, or any other court of equity, would have exercised such compulsion only if plaintiff had been under an obligation to file consolidated returns. The existence of that obligation cannot be proved by speculations as to what action the bankruptcy court might have taken.

2. Had plaintiff enjoyed taxable income of its own, it could have used its tax credit to minimize its own taxes. In that case no one would dream to argue that plaintiff was under a duty to surrender its tax credit to defendant. No clearer proof is possible that the tax credit was a valu-

* Appellees would distinguish this case on the ground that the present plaintiff had become a party to defendant's reorganization (DB 41). But plaintiff was permitted to intervene in defendant's reorganization because it was "an unsecured creditor and the sole stockholder of" defendant (R. 1994); it thus submitted itself to the bankruptcy court's jurisdiction with respect to its own claims against the debtor, not with respect to any claims the debtor might assert against it.

able right of plaintiff which it was not obligated to give away. The fact that plaintiff actually had no income of its own does not affect its rights; for the owner's inability to use his property gives no right to others to appropriate it.

3. Appellees say that it "cost the Corporation nothing" to surrender its tax credit to defendant (DB 32). Even if that were true, it would not follow that defendant had a right to appropriate plaintiff's tax credit or that plaintiff was obligated to surrender it. But appellees' premise is wrong:

(a) To begin with, plaintiff's joining in consolidated returns subjected it to liability for any tax deficiency of defendant; Treas. Reg. 104, § 23.15(a) (IntOB App. 12). It would seem preposterous to suggest that plaintiff was obligated to make itself the surety of defendant's undetermined tax obligations.

(b) The value of plaintiff's tax credit must be determined as of the time defendant appropriated it, i.e., July 15, 1944 (the date of the 1943 returns). At that time plaintiff had a real possibility of utilizing its tax credit to its own direct benefit. The fact that plaintiff's tax credit could be carried forward as far as 1945, could have been utilized to attract new capital investments in plaintiff; and plaintiff, with such new financing, could have enjoyed the benefit of its tax credit. See *Alprosa Watch Corp.* v. *Commissioner,* 11 T. C. 240 (1948), the facts of which are set forth in the footnote.* Plaintiff's management, devoted

* The taxpayer in the *Alprosa Watch* case was a corporation engaged in the business of manufacturing and selling gloves under the name of "Esspi Glove Corporation". It sustained a substantial loss in its operations. The stockholders of the corporation thereupon sold their stock to a new group. The new stockholders changed the name of the taxpayer to "Alprosa Watch Corporation", moved its business to new quarters and caused the corporation to give up the glove business and to engage in the business of purchasing and selling jewelry. The Tax Court held that the corporation could use the loss sustained in its glove business as a tax credit against the profits made in its jewelry business.

solely to the interests of defendant, entertained no such thoughts; but that does not change the fact that plaintiff's tax credit could have been the instrument of breathing new life into plaintiff. It was therefore an asset of real and substantial value; and the contention that its surrender to defendant cost plaintiff nothing is plainly wrong.

(c) Apart from all these considerations, plaintiff's tax credit was a valuable asset because defendant needed it and was in a position to derive benefits from it. The tax credit thus had "a 'sale' value of which the ceiling is the amount of such benefits" as defendant could realize therefrom; *Truncale* v. *Universal Pictures Co.,* 76 F. Supp. 465, 469 (D. C., S. D. N. Y., 1948). This point has been more fully developed in our opening brief (pp. 56-57); appellees have not answered what we there said; and their attempted distinction of the *Truncale* case (DB 45-46) has no bearing on its aspect here involved.

4. Appellees argue (DB 40) that it would have been wrong for plaintiff "to require payment for the service of signing a paper" (i.e., the consolidated returns); that "a reorganization court pays nothing for nuisance value"; and that plaintiff would not have been permitted to drive "a hard bargain" with the trustees.

The argument completely misconceives the nature of our case. We never contended that plaintiff was entitled to payment for its signature. We did and do contend that the tax credit was plaintiff's; that it was created by law to mitigate plaintiff's stock loss; that, before surrendering its tax credit to defendant, plaintiff was therefore entitled to demand an appropriate share of the resulting tax savings of defendant; that this demand would have been fair because consonant with the purpose of the tax laws; and that, because of the duality of management, defendant was required to deal fairly with plaintiff. Appellees' attempt to characterize our postulate as a nuisance bargain is far off the mark indeed.

**F. An agreement by defendant to allow plaintiff a fair share of the tax savings would not have destroyed those savings.**

Appellees argue (DB 39) that an agreement allowing plaintiff a share of the tax savings would have destroyed the savings themselves. For the possibility of using plaintiff's stock loss as a tax deduction depended upon the stock's becoming *completely* worthless; and, say appellees, if plaintiff received a tax benefit from its stock loss, that very fact would have demonstrated that the stock still had some value to plaintiff.

The argument borders on the absurd.

(a) If appellees were right, no stock loss could ever be used as a tax deduction. For, according to appellees, the tax deduction flowing from the stock loss would demonstrate that the stock was not yet completely worthless; and hence the tax deduction would have to be disallowed. Such circular reasoning would, of course, defeat the very purpose of I. R. C., § 23(g)(4), to mitigate a stock loss by allowing it as a tax deduction.

By the same token, if plaintiff had been permitted a share in the tax savings resulting from its stock loss, the stock would nevertheless have been completely worthless, since the payment would have been made not for the stock, but for the use of the tax credit.

(b) Appellees (DB 39) invoke a Treasury ruling, I. T. 3252 (1939-1 Cum. Bull. 182). The taxpayer there had made an executory contract for the sale of certain stock. The stock thereafter became worthless, but the taxpayer was still entitled to receive the purchase price. The taxpayer's claim for a tax deduction on the ground that the stock had become worthless was disallowed—necessarily so since the depreciation of the stock did not affect the taxpayer. No analogy flows from this case to ours, where the complete worthlessness of defendant's stock held by plaintiff was indisputable.

**G. Plaintiff's claim is not inconsistent with defendant's reorganization.**

Appellees argue (DB 59, 66) that, in defendant's reorganization, its secured creditors were not paid in full; that plaintiff, as stockholder of defendant, ranked behind the secured creditors; that, under the absolute priority rule of the *Boyd* case,* plaintiff could receive nothing until its seniors were paid in full; and that the allowance of plaintiff's present claim would violate this principle.

This reasoning is, in essence, the same as that of the Court below which held that the allowance of plaintiff's claim would be contrary to defendant's reorganization plan (R. 272-4). It has been answered in our opening brief (pp. 64-65).

1. The absolute priority rule requires that stockholders shall not participate in a corporate reorganization so long as senior claimants are not satisfied in full. This principle was meticulously followed in defendant's reorganization; defendant's stock held by plaintiff was completely wiped out. Indeed, the complete worthlessness of plaintiff's stockholdings in defendant was the basis upon which plaintiff became entitled to a tax credit under I. R. C., § 23(g)(4).

But once this elimination of the old stock in defendant was accomplished, the operation of the absolute priority rule was at an end. Certainly the rule does not require the denial of claims arising *during reorganization* solely because the claimant happens to be a stockholder!

To illustrate: Suppose that a railroad, in the hands of reorganization trustees, negligently injures one of its passengers. Would it be argued that the passenger's claim for damages must be rejected because he happens to be a stockholder of the railroad and his stock is without equity? The answer would obviously be no; and it would be equally negative if the victim of the railroad's negligence should happen to be the owner of all its stock. The injured pas-

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* *Northern Pacific R. Co.* v. *Boyd,* 228 U. S. 482 (1913); *Case* v. *Los Angeles Lumber Co.,* 308 U. S. 106 (1939).

senger's claim for damages could not be defeated because his stock ranks junior to the secured creditors; or because, as the holder of all of the stock, he is claimed to be a fiduciary; or because, under the Bankruptcy Act, he is required to preserve the assets of the railroad.

The present case is not different. Plaintiff's stockholdings in defendant were eliminated in conformity with the priority rule. But after this was done, defendant used plaintiff's tax credit. This gave rise to a new claim on plaintiff's part—not for the recognition of its stock interest in defendant, but for the use of its tax credit. It is therefore idle to contend that the assertion of this claim is contrary to the principle of priority or to the reorganization plan's purpose to eliminate plaintiff's stockholdings in defendant.

2. Appellees argue *ad misericordiam* that plaintiff's claim would "undermine the financial position" of defendant (DB 42). But actually it would leave defendant where the bankruptcy courts intended to place it and where defendant itself and its security holders counted on being placed. When the Supreme Court passed on defendant's reorganization plan, the junior interests demanded consideration because of defendant's "unexpectedly large earnings"; *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448, at 508 (1943). In answer the Supreme Court referred to the "effect of taxation" which was "more likely to affect net earnings" (*ibid.*). Defendant's new capitalization was thus based on the assumption that it would have to pay the normal taxes; and of this fact defendant gave warning to the world by setting aside a $10,000,000 tax reserve. Defendant has now succeeded in avoiding these taxes. Its security holders thereby obtained a windfall which the Supreme Court never contemplated giving them. But the windfall came from the use of plaintiff's tax credit. To say, under these circumstances, that plaintiff's claim to a fair share in this windfall would "deplete the assets" of defendant (DB 66) is little less than a parody on the facts.

**H. The amount of plaintiff's recovery should be determined in conformance with the purpose of the tax laws.**

Our briefs, we believe, have shown that plaintiff's treatment by defendant—the denial to plaintiff of any and all benefit from the tax transaction—was clearly unfair. It remains to consider the amount of relief that will cure the wrong. Fairness again must be the guidepost.

1. In determining the requirements of fairness, the Court will not, as appellees suggest, try to "make a retrospective bargain" (DB 39). The courtroom is not the market place. Once a transaction between fiduciary and cestui is recognized as unfair, the consequences follow as a matter of law.* The superior negotiating skill of one party, the economic weakness of the other may fashion the terms of a deal between parties transacting at arm's length. But these factors are of no account in the judicial award of what is fair; objective standards, such as those applied in *Chelrob* v. *Barrett*, 293 N. Y. 442, 57 N. E. 2d 825 (1944), control.

2. It is our primary contention that plaintiff is entitled to the full amount of the tax savings. That follows from the purpose of the tax laws to confer a tax benefit on plaintiff, not on defendant. In cases comparable to ours, this solution was held to be fair. *Matter of Consolidated Electric & Gas Co.*, 15 S. E. C. 161 (1943); *Matter of Cities Service Co.* (S. E. C. Holding Company Act Release No. 5535, January 3, 1945, File No. 70-988, discussed IntOB 46). But should the Court find some equity in defendant's having contributed to the achievement of the savings, then, we submit, fairness dictates that plaintiff is entitled to at least half of the savings which the use of its tax credit made possible.

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* Appellees' argument that "the reorganization trustees [of defendant] are not parties to this proceeding" (DB 39) is beside the point since defendant has by contract assumed all obligations of the trustees (R. 78, 1712-3; *infra*, p. 28).

## POINT III

**The defense of bankruptcy bar is unsound because contrary to an express statute and a long line of authorities.**

Appellees contend (DB 68) that plaintiff's claim, even though originally valid, was barred by plaintiff's failure to have it approved by the bankruptcy court. Payment of plaintiff's claim, it is said, would have been an expense of reorganization; the bankruptcy court, according to appellees, had exclusive jurisdiction to pass on the claim; and plaintiff failed to present it to the only competent forum (DB 68).

Before answering this argument, it is necessary to deal with two preliminary points. For intermingled with their argument just mentioned, appellees present two others: That the reorganization trustees, against whom the claim was originally directed, did not have the necessary authority from the bankruptcy court to incur such liability (DB 72-74); and that, in any event, the liability is that of the trustees and was never assumed by defendant (DB 20, 75-79). Since these two contentions are not strictly germane to the defense of bankruptcy bar, we shall dispose of them in advance before turning to appellees' main argument.

Accordingly, we shall show under this pointhead that:

1. The authorization of the bankruptcy court was not a prerequisite of plaintiff's claim; moreover, such authorization was given (A, *infra*);

2. To the extent that plaintiff's claim was originally directed against the reorganization trustees, it was validly assumed by defendant (B, *infra*); and

3. Plaintiff was, by express statute, relieved from any requirement to present its claim to the bankruptcy court (C, *infra*).

**A. The authorization of the bankruptcy court was not a prerequisite of plaintiff's claim; moreover such authorization was given.**

Appellees argue (DB 72-74) that a reorganization trustee cannot validly incur any liability without approval of the court. Here the bankruptcy court directed that "any extraordinary expense" was to be "subject to the prior approval of the Court" (R. 1910, 1929). The liability to plaintiff, it is said, was an "extraordinary expense" and did not have prior court approval.

There are many difficulties with this argument.

1. The consolidated returns for 1944 and the refund claim for 1942 were both filed in 1945 (Pl. Exs. 5, 6), long after defendant had emerged from reorganization on December 29, 1944 (R. 499). The trustees had, therefore, nothing to do with these transactions, so that the rule requiring court approval of their liabilities could not come into play.

2. The rule was also inapplicable to the returns for 1943. The doctrine that reorganization trustees cannot incur liabilities without court approval is limited to *contract obligations;* see *Chicago Deposit Vault Co.* v. *McNulta,* 153 U. S. 554, 562 (1894).* A trustee who in the conduct of the debtor's business violates the anti-trust laws, or engages in unfair competition, or appropriates the property of another, cannot escape liability by saying that his incurring any of these liabilities was an "extraordinary expense" not authorized by the court. Each of the authorities cited by

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* The Supreme Court, quoting from *Lehigh Coal & Nav. Co.* v. *Central R. Co.,* 35 N. J. Eq. 426, held

> "'* * * he [the receiver] has no authority to bind the trust *by contract* without the authority of the court. Until his contracts are approved and ratified by the court the court is at liberty to deal with them as to it shall appear just, and may either modify them or disregard them entirely * * *.'
>
> "This states the correct rule upon the subject * * *"
>
> (153 U. S., at 562; italics added)

appellees (DB 72, 74) involved express contract obligations arising, e.g., from a lease *, from a loan of money,** from the purchase of goods,*** or from a retainer agreement.† The present claim is based on a breach of fiduciary duty and is therefore non-contractual.

3. The present claim is not an "extraordinary expense". The filing of tax returns is an ordinary and necessary incident of running a railroad. Appellees themselves proclaim that "these tax transactions were handled in the ordinary course of business" (DB 12) and were carried on in a "routine" fashion (DB 21). The mere fact that the expense is large does not render it "extraordinary".

4. If court approval were deemed necessary, it is found in the bankruptcy court's order of March 3, 1944 (Def. Ex. 12, R. 1895). By this order the court, having been notified of the trustees' intention to file consolidated returns for 1943 and to use plaintiff's stock loss (R. 1271-2, 2025), authorized the creation of a tax reserve in connection with these returns. While the bankruptcy court did not pass on the propriety of the proposed tax transactions, it certainly cannot be argued that what the trustees did was beyond the scope of their authority. It follows that they and the estate administered by them became liable for the consequences of their conduct; *Vass* v. *Conron Bros. Co.*, 59 F. 2d 969, 970 (C. C. A. 2, 1932).

5. But even if it were assumed, *arguendo,* that the trustees exceeded their authority, they would still have incurred personal liability; *In re Kalb & Berger Mfg. Co.*, 165 Fed. 895, 896 (C. C. A. 2, 1908). Such liability was

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* *Chicago Deposit Vault Co.* v. *McNulta*, 153 U. S. 554 (1894).

** *Northern Finance Corp.* v. *Byrnes,* 5 F. 2d 11 (C. C. A. 8, 1925); *Byrnes* v. *Missouri National Bank,* 7 F. 2d 978 (C. C. A. 8, 1925).

*** *In re Erie Lumber Co.,* 150 Fed. 817 (D. C., S. D. Ga., 1906).

† *Leiman* v. *Guttman,* 336 U. S. 1 (1949).

covered by defendant's assumption agreement, to be presently discussed, since, as appellees admit, that agreement was couched in broad language "in order to give the trustees full protection against personal liabilities" (DB 76). We submit that an obligation of the trustees for the 1943 tax savings is indisputable.

**B. To the extent that plaintiff's claim was originally directed against the reorganization trustees, it was validly assumed by the defendant.**

Appellees contend that the tax savings were those of the trustees (DB 1, 6, 20); that plaintiff's claim is therefore directed against the trustees; and that defendant did not assume this liability of the trustees (DB 20, 75-79).

This argument, like that just discussed, can apply only to the taxes for 1943. As we have shown, the returns for 1944 and the refund claim for 1942 were filed after defendant had emerged from reorganization; the trustees had therefore nothing to do with these tax transactions; and the liability arising therefrom was, from the very outset, that of defendant.

We agree, however, with appellees that the returns for 1943 were filed while the trustees were still in charge, and were consented to by the trustees as required by Treas. Reg. 104, § 23.12(b) (IntOB App. 11). The liability to plaintiff arising from this transaction was therefore originally that of the trustees. But defendant, by a clear and unequivocal contract, approved by the bankruptcy court, assumed this liability.

1. Toward the end of 1944, defendant was ready to come out of reorganization. Accordingly, the bankruptcy court made its so-called revesting order of November 27, 1944 (Pl. Ex. 14, R. 1711, 36-108), by which it directed the trustees to return the properties in their hands to defendant, and directed defendant to assume certain liabilities and obligations of the trustees. Paragraph 8(a) of the revesting order (R. 46) prescribed and approved spe-

cifically the terms of the assumption agreement to be executed by defendant (R. 76-81). Pursuant to this direction, the assumption agreement was executed by defendant on December 14, 1944 (Pl. Ex. 15, R. 1711, 76).

So far as here pertinent, the assumption agreement provides that

> "the undersigned [i.e., defendant] does hereby:
>
> * * * * * *
>
> "2. Assume any and all outstanding current liabilities and obligations incurred by said Trustees and without limitation thereto, any and all liabilities or obligations of the debtor in possession or said Trustees with respect to claims for personal injury or death, for loss or damage to property and generally any and all liabilities and obligations with respect to claims of any character whether heretofore or hereafter asserted arising out of the possession, use or operation of the debtor's properties by said Trustees, or their conduct of the debtor's business, including liabilities and obligations hereafter arising up to midnight December 31, 1944."
>
> (R. 78, 1712-1713)

The assumption agreement thus included "any and all liabilities and obligations with respect to claims of any character * * * arising out of the possession, use or operation of the debtor's properties by said Trustees, or their conduct of the debtor's business". The language could not have been broader. It requires no elaboration that plaintiff's claim arose from the trustees' "conduct of the debtor's business", since the filing of tax returns was a necessary incident of the conduct of the debtor's business. Indeed, appellees do not contend otherwise.

(It should be added that defendant also assumed all federal tax liabilities of the trustees, R. 1716.)

2. Appellees contend, nevertheless, that the assumption agreement did not embrace the present claim. But their arguments cannot prevail against the clear language of the agreement.

(a) In the first place, appellees say that the agreement applied only to "recognized debts" (DB 76). But the agreement contains no such qualification; on the contrary, it covers claims "heretofore or hereafter asserted". If, for instance, a negligence claim arose against the trustees on the day before the agreement was signed, it did not constitute a recognized debt; still it was clearly assumed by defendant.

(b) Appellants say next that the agreement did not eliminate the necessity that expenses of administration be approved by the bankruptcy court (DB 76). But that is a different problem, to be dealt with below (C, *infra,* p. 31): it relates to the method of enforcing the claim and has nothing to do with the breadth of the assumption agreement.

(c) Appellants further say that the assumption agreement did not embrace *all* obligations of the trustees because the revesting order described the agreement as covering "certain obligations" of the trustees, only those "valid and outstanding". But the obligation here asserted was a valid one; and the phrase "certain" was justified because defendant assumed only those obligations of the trustees arising from their conduct of the debtor's business and only those incurred up to December 31, 1944.

(d) Appellees next refer to plaintiff's "failure to obtain court approval of their claim" (DB 77). That argument has been answered (A, *supra,* p. 26).

(e) Appellees finally refer to a provision of the reorganization plan stating that defendant was to assume the "current liabilities and obligations incurred by the trustees". The pertinence of this provision does not appear since our claim is not based on the terms of the reorganization plan, but on the assumption agreement as approved by the bankruptcy court's revesting order.

Even if it were assumed, *arguendo,* that defendant assumed only the "current liabilities and obligations" of the trustees, the present claim would still be covered. For

appellees themselves contend that the claim constituted an "expense of administration" (DB 68); and "if it is an expense of administration, it fits within the category of the current liabilities of the receivers referred to as payable [by the reorganized debtor] in the plan of reorganization", *In re Pressed Steel Car Co. of New Jersey*, 100 F. 2d 147, 150 (C. C. A. 3, 1938), cert. den. 306 U. S. 648.*

Plaintiff's claim for the 1943 tax savings was therefore clearly covered by defendant's assumption agreement of December 14, 1944.

**C. Plaintiff was, by express statute, relieved from any requirement to present its claim to the bankruptcy court.**

Appellees' contention that the bankruptcy court was the exclusive forum to determine plaintiff's claim to the 1943 tax savings **—because the claim was an expense of administration—is contrary to § 66 of the (old) Judicial Code, 28 U. S. C. § 125 (old),*** which provides:

> "Every receiver or manager of any property appointed by any court of the United States may be sued in respect of any act or transaction of his in carrying on the business connected with such property, without the previous leave of the court in which such receiver or manager was appointed; but such suit shall be subject to the general equity jurisdiction of the court

* The term "current liabilities" has different meanings, depending on the context in which it is used, as appears from the different definitions cited by appellees (DB 78, fn. 54). None of appellees' authorities dealt with the term "current liabilities" as used in the assumption clause of a reorganization plan; whereas the *Pressed Steel Car* case, *supra,* deals with that very problem.

** Plaintiff's other claims arose in 1945, after defendant had emerged from reorganization, and are therefore not expenses of administration.

*** The statute was enacted by § 3 of the Act of March 3, 1887 (24 Stat. 554), amended in 1888 (25 Stat. 436) and 1911 (36 Stat. 1104). Since September 1, 1948, the section has been replaced by § 959 of the (new) Judicial Code, 28 U. S. C. § 959 (new).

> in which such manager or receiver was appointed so far as the same may be necessary to the ends of justice."

This statute applies to the reorganization trustees of a railroad appointed under § 77 of the Bankruptcy Act; *Thompson* v. *Texas Mexican R. Co.,* 328 U. S. 134, 138 (1946); *Jacobowitz* v. *Thomson,* 141 F. 2d 72, 75 (C. C. A. 2, 1944); *Ziegler* v. *Pitney,* 139 F. 2d 595, 596 (C. C. A. 2, 1943).

We shall demonstrate that the statute would have authorized plaintiff to sue defendant's reorganization trustees without resort to the bankruptcy court, regardless of whether the claim was an "expense of administration"; that defendant, having assumed the obligations of the trustees, is equally amenable to suit; and that, under the statute, the injunctive orders of the bankruptcy court, invoked by appellees (DB 79-82), are no obstacle to this action.

1. *The statute would have authorized plaintiff to sue the reorganization trustees without resort to the bankruptcy court.*

> "This act [i.e., Judicial Code, § 66] abrogated the rule that a receiver could not be sued without leave of the court appointing him, and gave the citizen the unconditional right to bring his action in the local courts * * *. He ceased to be compelled to litigate * * * in any other forum * * * than he would be entitled to if the property or business were not being administered by the Federal court."
>
> *Gableman* v. *Peoria, D. & E. R. Co.,* 179 U. S. 335, 338 (1900).

> "Necessarily, such suit may be brought in any court of competent jurisdiction and proceed to judgment accordingly."
>
> *Texas & P. R. Co.* v. *Johnson,* 151 U. S. 81, 101 (1894).

The qualifying clause of the statute—that the suit shall be subject to the general equity jurisdiction of the appointing court—does not restrict the plaintiff's right to sue the trustees or receiver outside the bankruptcy court; for "the right to sue without resorting to the appointing court * * * cannot be assumed to have been rendered practically valueless by this further provision in the same section of the statute which granted it"; *Johnson* case, *supra,* 151 U. S., at 103. The qualifying clause of the statute relates only to "the mode of enforcing such claim when judicially determined and liquidated"; *American Brake Shoe & F. Co.* v. *Pere Marquette R. Co.,* 263 Fed. 237, 240 (D. C., E. D. Mich., 1920), citing authorities; *Kennison* v. *Philadelphia & R. C. & I. Co.,* 38 F. Supp. 980, 983 (D. C., Minn., 1940); see *Willcox* v. *Jones,* 177 Fed. 870, 874-5 (C. C. A. 4, 1910).

Nearly all claims which fall under § 66 constitute "expenses of administration"; certainly "tort claims arising by virtue of the business operations of the debtor" come within that classification, 6 *Collier on Bankruptcy* (14th Ed., 1947), § 10.06, pp. 3462-3. Nevertheless their assertion outside the bankruptcy court is a matter of indisputable statutory right, established by the authorities cited and many others.

In the present case the trustees operated defendant's railroad properties pursuant to an order of the bankruptcy court (Def. Exs. 20, 22, R. 1908, 1923). Their liability arose from a transaction of theirs in carrying on this business, since their or their agents' act * in causing plaintiff to file consolidated returns and in joining therein was an incident of that business. It follows that plaintiff could have sued the trustees "in any court of competent jurisdiction", without leave from, or resort to, the bankruptcy court.

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* The statutory language, permitting suit against the receiver "in respect of any act or transaction *of his*", includes the acts and transactions of his agents; *McNulta* v. *Lochridge,* 141 U. S. 327, 331 (1891).

2. *Defendant, having assumed the obligation of the trustees, is equally amenable to suit.* A plaintiff who is authorized, by statute, to sue a court-appointed trustee in a forum other than the bankruptcy court appointing him, must *a fortiori* have the same freedom when suing a private corporation which has assumed the obligations of the trustee. It is unthinkable that a bankruptcy court, which is unable to shield its own officers from suits in another forum under § 66, should have power to prevent like suits against the debtor which has emerged from reorganization and assumed the liabilities of the trustees. It is equally unthinkable that the bankruptcy court's jurisdiction, which was non-exclusive during the reorganization, should become exclusive when the reorganization ends.

The courts unanimously agree with our position:

*Chicago G. W. R. Co.* v. *Hulbert,* 205 Fed. 248, 250-1 (C. C. A. 8, 1913);

*American Brake Shoe & F. Co.* v. *Pere Marquette R. Co.,* 263 Fed. 237, 240 (D. C., E. D. Mich., 1920);

*Gray* v. *Grand Trunk W. R. Co.,* 156 Fed. 736 (C. C. A. 7, 1907);

*Hanlon* v. *Smith,* 175 Fed. 192 (C. C., N. D. Iowa, 1909);

*Lassiter* v. *Norfolk S. R. Co.,* 163 N. C. 19, 21-22, 79 S. E. 264 (1913);

*Denver & R. G. R. Co.* v. *Gunning,* 33 Colo. 280, 292-3, 80 Pac. 727 (1905);

*Hawkins* v. *St. Louis & S. F. R. Co.,* 202 S. W. 1060, 1063-4 (Mo. App., 1918, not otherwise reported);

*Bremer* v. *Chicago & E. I. R. Co.,* 247 Ill. App. 406, 413 (1927, not otherwise reported);

*Vandalia R. Co.* v. *Keys,* 46 Ind. App. 353, 366-7, 97 N. E. 173 (1910);

*Kansas City, M. & O. R. Co.* v. *Latham,* 182 S. W. 717, 720 (Tex. Civ. App., 1915, not otherwise reported).

In each of these cases the receiver or trustee of a railroad had, in the conduct of the railroad's business, incurred liability to the plaintiff; upon consummation of the receivership (mostly by foreclosure sale), the reorganized railroad assumed the liabilities of the receiver; the plaintiff sued the reorganized railroad without leave from the bankruptcy court and without having his claim approved by the bankruptcy court. In each case the action was sustained.

> " * * * the terms of the statute just quoted [i.e., Judicial Code, § 66] are now as fairly applicable to said petitioner [i.e., the reorganized railroad] as they would have been to the receivers whom they have succeeded, if the latter had not been discharged and, they, instead of petitioner, had been sued in respect of the alleged negligence of their servants in the suit which is the subject of this controversy. This suit was properly brought in the State court, and the latter has full jurisdiction to determine all of the issues involved therein without interference by this court [i.e., the bankruptcy court]. Texas & Pacific Railway Co. v. Johnson, 151 U. S. 81; [citing numerous additional authorities]."
>
> *American Brake Shoe* case, *supra,* 263 Fed., at 240.

> "Inasmuch as an action can be brought in the State court against the receivers in the Federal court, without obtaining permission of that court (U. S. Compiled Statutes, 721(3), Act 3 March 1887, ch. 373, sec. 3), *a fortiori* an action can be brought in the State court against the purchaser, after confirmation of the sale and delivery of the property to such purchaser, without permission of the Federal court."
>
> *Lassiter* case, *supra,* 163 N. C., at 21-22.

These cases are on all fours with that at bar. Plaintiff may therefore maintain this action against defendant without previous approval of its claim by the bankruptcy court.

3. *The injunctive orders of the bankruptcy court are no obstacle to this action.* Appellees (DB 79-82) invoke cer-

tain clauses of the bankruptcy court's revesting order of November 27, 1944 (R. 51-52, 59-60, 62) and of its final order of March 28, 1946 (R. 2017-8) on the theory that they bar this action. But they do nothing of the kind.

In the first place, the bankruptcy court had no power to enjoin or bar the bringing of suits authorized by Judicial Code, § 66. "It is entirely clear from the Gableman case [*supra,* 179 U. S. 335], and many other decisions in the Circuit Courts of Appeals and Circuit Courts, that no power exists in this court to restrain or stay receiver suits in the state courts"; *Smith* v. *Jones L. & M. Co.,* 200 Fed. 647, 650 (D. C., W. D. Wis., 1912). In the *Lassiter* case, *supra* (163 N. C. 19), the receivership court had reserved "exclusive jurisdiction of this case * * * for the purpose of enforcing all the obligations and rights assumed by said grantee". Nevertheless, an action brought in the state court against the grantee railroad, based on the liability of the receiver, was sustained:

> "We do not understand that the right which the plaintiff has under the Federal and State statutes to bring this action in the State Court can be impaired by this decree of the Federal court, nor do we think that such decree was intended to have such effect."

All of the cases cited, *supra,* p. 34, involved injunctive provisions similar to, or even stronger than those at bar. Nevertheless, the actions were permitted to go to judgment.

However, the injunctive orders in the present case, even if they were considered wholly apart from § 66, would not bar the present suit. Thus the revesting order provided that defendant's assets were to be "free and clear" of the rights of any persons, "except as is otherwise provided in this order" (R. 51-52); and it was otherwise provided by that part of the order directing defendant to execute the assumption agreement.

The revesting order also contained the customary blanket injunction restraining all persons from "disturbing" de-

fendant's assets or properties "by reason of or growing out of any obligation or obligations heretofore incurred by the debtor or the debtor's Trustees herein" (R. 59-60). Obviously this sweeping language was not intended to nullify the assumption agreement which had been authorized by another clause of the same order; hence the injunction must be construed as qualified by the assumption agreement. A similar restrictive interpretation of a blanket injunction is found in *Kennison* v. *Philadelphia & R. C. & I. Co., supra,* 38 F. Supp., at 982-3.

Nor can appellees derive comfort from the blanket injunction of the final order of March 28, 1946, which was qualified by the phrase, "except as specifically provided for or permitted by prior order of this Court" (R. 2017-8). Such "prior order" was the revesting order which had sanctioned defendant's assumption agreement.

We submit, therefore, that the bankruptcy court did not have the power and did not purport to enjoin or bar the prosecution of this action.

4. *Appellee's authorities are not in point.* Appellees' principal reliance (DB 74) is on *McColgan* v. *Maier Brewing Co.,* 134 F. 2d 385 (C. C. A. 9, 1943), cert. den. 320 U. S. 737, which held that state franchise taxes, accrued against a corporation's bankruptcy receiver but not presented to the bankruptcy court, were discharged by the approval of a plan of composition; the corporation, having emerged from the receivership, was held not to be bound to pay these taxes. The simple reason is that the corporation, otherwise than the present defendant, did not assume the liabilities of the receiver:

> "Upon confirmation of the plan for composing of the debts of the Maier Brewing Company, the receiver was discharged and the property *unconditionally* turned back to the corporation. Does the property so returned remain liable for debts incurred by the receiver in the course of administration? We understand not, *unless the court has so directed.*"
>
> (134 F. 2d, at 387; italics added)

Here the court has "so directed" by ordering defendant to execute the assumption agreement. An additional distinction of the *McColgan* case is that the receiver's franchise tax liability did not arise from an "act or transaction of his" within Judicial Code, § 66; that statute, of such importance here, is therefore not even mentioned in the *McColgan* opinion.

Like reasons distinguish this case from *Duryee* v. *Erie R. Co.*, 175 F. 2d 58 (C. A. 6, 1949), cert. den. 338 U. S. 861, and from *In re Colorado & S. R. Co.*, 84 F. Supp. 134 (D. C. Colo., 1949), cert. den. 338 U. S. 847. Indeed, the liabilities there asserted were not those of a receiver or trustee, but had arisen prior to reorganization (175 F. 2d, at 59) and were therefore provable claims (84 F. Supp., at 145), not within the purview of § 66. And in neither of the two cases did the reorganized debtor execute an assumption agreement.

Appellees preface their arguments with certain generalizations of doubtful accuracy. They assert that "the reorganization court must consider and pass upon all possible claims which might be asserted against the reorganized company" (DB 69). This is true of provable claims; it is not true of trustees' liabilities under § 66. Appellees also proclaim that "the reorganization must put an end to all outstanding claims" (DB 70). This is simply not so where, as here, outstanding claims are provided for by what appellees themselves (DB 76) describe as the "conventional" device of an assumption agreement.

It is therefore submitted that the defense of bankruptcy bar is without merit and should be rejected.

## POINT IV

**The defenses of res judicata and Statute of Limitations are without merit.**

These defenses, set forth in a footnote of appellees' brief (p. 82), are on their face untenable.

1. *The defense of res judicata* is based on appellees' statement that "a litigant who asserts claims against an estate in the hands of the court must in the first proceeding assert all of his claims or be forever foreclosed" (DB 82). However, res judicata applies only where the cause of action in the second suit is the same as in the first; *Restatement, Judgments* (1942), §§ 47, 48. Such identity existed in the cases cited by appellees, as is shown by the statement that "The parties, the subject-matter and the relief sought, all were the same"; *U. S.* v. *California & O. L. Co.,* 192 U. S. 355, 358 (1904). The present plaintiff's demand that its stock interest be recognized in defendant's reorganization was certainly not the same as its claim in the case at bar to a share in defendant's tax savings.

2. *The Statute of Limitations* is said to bar plaintiff's claim to the 1943 tax savings, because the 1943 returns were filed on July 15, 1944, more than two years before the commencement of this action on October 10, 1946 (Calif. Code Civ. Proc., § 339(1)). However, the cause of action which accrued on July 15, 1944 was directed against the trustees. Defendant's liability rests on its assumption agreement of December 14, 1944. On that date—less than two years before the commencement of this action—a new statutory period began to run with respect to plaintiff's cause of action against defendant. *Bogart* v. *George K. Porter Co.,* 193 Cal. 197, 202, 223 Pac. 959 (1924); *Anderson* v. *Calaveras Central Mining Corp.,* 13 Cal. App. 2d 338, 345, 57 Pac. 2d 560 (1936); *Daniels* v. *Johnson*, 129

Cal. 415, 61 Pac. 1107 (1900). Since the assumption agreement was a written contract within the purview of Calif. Code Civ. Proc., § 337(1), the statutory period for plaintiff's claim, based on that agreement, was four years, and had clearly not expired when this action was commenced.

Respectfully submitted,

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